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# Yale Program on Financial Stability

## Lessons Learned

Diane Ellis

By Sandra Ward

*Diane Ellis served as Deputy Director, Insurance and Research, at the Federal Deposit Insurance Corp. during the financial crisis of 2007-09. The FDIC played a critical role in stabilizing financial conditions and establishing confidence in the financial markets by guaranteeing newly issued debt on a temporary basis for banks and thrifts as well as financial holding companies and eligible bank affiliates. The agency also fully guaranteed certain non-interest-bearing transaction deposit accounts. Ellis played an important role in implementing the Temporary Liquidity Guarantee Program that proved so critical in stemming the crisis. This "Lessons Learned" is based on a phone interview with Ms. Ellis.*

**Although not the first agency to address the crisis, the FDIC played a critical role.**

In 2007, as the crisis began to unfold, Ellis recalls that the FDIC wasn't much involved in the discussion of how best to handle what was happening and what could be done to stem a possible meltdown. Its bank examiners had begun to get drawn in—Bear Stearns held some depository institutions that required FDIC supervision, for instance—but it wasn't until the failure of IndyMac in July 2008 that the crisis landed on the doorstep of the FDIC as it faced a major resolution problem. Recalls Ellis,

We had a reasonably sized institution that we weren't prepared to resolve. We had to put it in conservatorship for a while, and our resolution specialists were all occupied doing that. It was such a hit to our deposit insurance fund that our deposit insurance fund was getting close to insolvent. To me, that's the event when the FDIC really got involved.

Still, Ellis remembers, not until Columbus Day weekend 2008, after the historic collapse of Lehman Brothers and in the wake of numerous high-profile bank failures, did the Treasury and Federal Reserve turn to the FDIC about playing a role. The way that role evolved demonstrated some of the challenges of a major crisis when many parties are needed to implement a viable solution.

The Treasury and the Federal Reserve were interested in accessing the FDIC's systemic risk exception authority that would be required to provide the large-scale relief and debt guarantee programs that would ultimately boost confidence and stabilize the system. Ellis notes that the decision to implement a debt guarantee program was determined by outside agencies and, yet, left for the FDIC to manage.

She remembers the pressure,

Policymakers were saying "You've got to do this debt guarantee program. You have the authority to do this. This is what the U.S. needs. This is what the G7 countries already have. And if you don't do it, then the collapse of capitalism will be your fault."

It was thrust upon us. That's when FDIC Chair Sheila Bair said, "If I'm going to do this, this is what I want: I want to limit the guarantee to only new debt, and I want the Transaction Account Guarantee [TAG]," and so on.

According to Ellis, as a result of Bair's diplomatic approach, the programs proved more palatable, eliminated political resistance from smaller banks, and were seen as critical to stabilizing the financial system.

### **For federal regulatory programs to work best, seek industry input.**

The Temporary Liquidity Guarantee Program (TLGP), in which the FDIC agreed to guarantee the debt of financial institutions, was an elegant solution to unlock the debt markets and get credit flowing again, notes Ellis. Initially, however, the banks balked at participating, and the hesitancy puzzled regulators. The FDIC contacted industry participants to learn why they were reluctant to participate. Industry's advice: act as a guarantor and stop acting as an insurer. And that required a restructuring of the design of the program. Says Ellis,

That was a big leap for us internally because it was so different from the role we play in terms of providing deposit insurance. We heard we were treating the debt relief as if it were insurance and we were treating the incidence of default like a bank failure. A guarantor steps in and makes timely payments of principal and interest.

Eventually, says Ellis, the program was structured as a true debt guarantee, in which timely payment of principal and interest are paid and the guarantee was backed ultimately by the U.S. government. Once the changes were made, banks responded quickly. "When we put that final rule in place, there was a big rush on the part of banks and holding companies to issue debt," Ellis recalls.

### **All bank problems wind up at the FDIC.**

The FDIC was formed and operates with a specific mandate. Prior to the 2007-09 crisis, the agency saw its domain as supervising and regulating insured depository institutions, says Ellis, and it viewed investment banks, so-called nonbanks, as a separate world to be monitored and followed but outside its bailiwick. That view changed completely once Lehman Brothers failed and the linkages between the banks and non-banks surfaced. Observes Ellis,

Lehman seemed separate from us. Now, we realize, well, maybe it wasn't quite as separate as we thought.

At the time, the press would refer to investment banks as banks. Morgan Stanley was a bank; Goldman Sachs was a bank. They were not banks. Yet, as it turned out, they were all banks in substance. Without Lehman's failure, I don't think there would have been any Columbus Day weekend need to intervene and there would be no TLGP and so on. Maybe there would be no Dodd-Frank or certainly no Title I and Title II rule.

Ellis adds that one of the key lessons that the FDIC learned from the crisis was the interconnectedness of the whole financial system. She says that before the GFC, the FDIC pretty much lived in its world of insured depository institutions and thought that all the problems and risks were in the nonbanks. Afterwards, she says, "I gained an appreciation of how everything really comes back to the banks."

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